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The price of cheap money

The World Bank's new World Development Report* argues that poor countries could save more, and make better use of the savings they already have, if they would only let their financial systems work

ONE of the biggest and most persistent difficulties for developing countries is that they save a lot less than they can usefully invest. Because of this lack of savings, they need foreign capital to build up their productive investment. In principle, that sounds fine. It makes economic sense for a poor country with good growth potential to borrow abroad. But foreign borrowing can be risky. In the 1980s many poor countries ran into crippling debt troubles because they had borrowed too much in earlier years, and because exchange rates and interest rates moved against them. To make matters worse, they had often invested the money in the wrong things—or had simply spent it on (public-sector) consumption.

Many words have since been devoted to the need to invest wisely, and on the need for more foreign capital to go to the developing countries. Less has been said about domestic saving. What can developing countries' governments do to promote it? And how can they make sure it is put to better use?

In many countries the answer to both questions is the same: higher interest rates. That will sound odd to some rich-country ears. Surely higher interest rates would discourage investment—the opposite of what is needed? Yes they would, if interest rates at present were set by the market. But in most poor countries they are not.

In a wide range of deliberate and accidental ways, governments distort their countries' domestic financial systems. Typically, they start by forcing intermediaries to lend at low interest rates. They do this precisely because they think it is important to boost investment—or certain sorts of it. But at these artificially low interest rates the demand for loans greatly exceeds the supply of deposits needed to fund them. So credit has to be "directed"—ie, rationed—to preferred borrowers. If the market were allowed to work, interest rates would rise to balance the demand for loans and the supply of deposits. There would be more deposits and more loans. Decisions over how much should be lent to whom and for what purpose would be made by market forces not bureaucrats. In short, there would be more and better investment.

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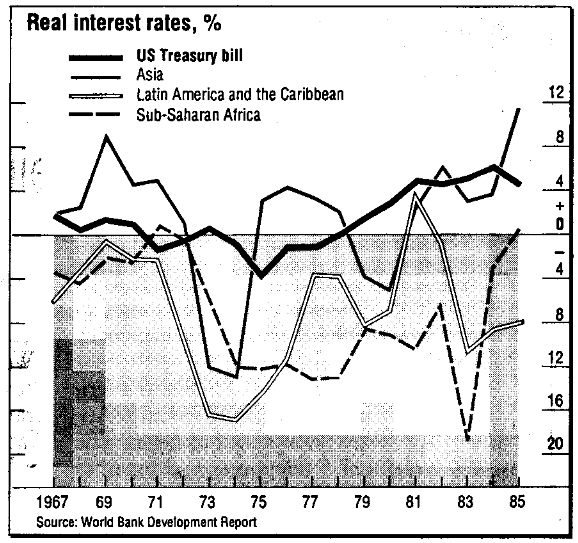

Source: World Bank Development Report

The chart shows the degree to which interest rates in developing countries have been distorted over the past two decades. Real interest rates in Latin America and in black Africa have been persistently negative. This means that savers have seen the real value of their deposits fall. In Latin America in the mid-1970s, deposits lost a sixth of their purchasing power annually; meanwhile borrowers made money on projects that would never have been launched at undistorted interest rates. Compare Latin America and Africa with Asia, which includes the fastest growing developing countries. Asia's interest rates have been higher, and often positive in real terms. Unsurprisingly, its savings and investment have been higher too.

To provide the right financial climate, the World Bank urges two main kinds of reform:

- **Microeconomic.** Governments should stop putting rigid ceilings on interest rates. Not only that, they should let the pattern of interest rates vary freely between different sorts of borrower, to reflect the risks and other costs that are borne by the lender. It is a mistake, for instance, for governments to tell banks—as they often do—to charge lower interest rates to small borrowers or for loans of longer maturity. By making such lending less profitable, governments may ensure that less of it is forthcoming.

Directed credit has sometimes worked—as in South Korea, for example—when aimed at a specific market imperfection (such as a lack of risk capital). But it is always better to tackle the underlying imperfection (thus, promote risk capital by letting it earn an adequate reward) than to leave it in place and slap a directed credit programme on top.

True, governments have to do more than stand aside and let markets get on with it. Financial systems need to be carefully regulated—not with the aim of allocating credit, but for prudential purposes. Governments need to build up the legal framework within which borrowers and lenders can meet and do business. That means providing for the enforcement of contracts, and setting out clear rules about bankruptcy. Governments should also encourage the growth of securities markets and other intermediaries—both to compete with banks, and to supply the longer-term credit that banks (with their base of mainly short-term deposits) cannot or should not provide.

- **Macroeconomic.** Those reforms cannot do much good against a background of chronic economic instability. Real interest rates have been artificially low in many developing countries because administered rates could not keep up with inflation. But it is not enough to keep inflation down by refraining from printing money, if that just means high government borrowing instead. Many governments have forced banks to lend to them at below-market rates, or have borrowed covertly through high reserve requirements. These policies are equivalent to heavy implicit taxes on domestic banks—with obvious results for the banks' ability to lend to the private sector. Even when governments do not cheat at all and borrow at market rates, they push those rates higher by adding their own demand to the economy's total demand for credit. This crowds out private borrowers. Sound public finance is a prerequisite for efficient private finance.

Most developing countries will be strapped for cash for the foreseeable future. Higher domestic saving, channelled through a more efficient and market-conscious financial system, is not the answer to all their worries. But it would be a big help, and should no longer be overlooked.

*World Development Report 1989. Oxford University Press. Our economics editor, Clive Crook, was seconded to the team that produced the report.